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C O N F I D E N T I A L SECTION 01 OF 04 BAKU 000031

SIPDIS

ANKARA FOR DAS BRYZA

E.O. 12958: DECL: 01/14/2019

TAGS: [PGOV](#) [PREL](#) [AJ](#) [TK](#) [ENRG](#)

SUBJECT: AZERBAIJAN: MOTION ON SHAH DENIZ PHASE TWO TURKEY
TALKS

REF: A) BAKU 1126 (2008) B) BAKU 1186 (2008) C)
ANKARA 56 D) BAKU 30

Classified By: CDA Don Lu, Reasons 1.4 (b,d)

11. (C) SUMMARY. According to Shah Deniz Consortium members SOCAR, StatoilHydro and BP Azerbaijan, there has been no progress in talks with Turkey on either the price of Shah Deniz Phase One gas currently being delivered to Turkey or on the marketing and transit of Shah Deniz Phase Two gas to and through Turkey. However, SOCAR President Rovnaq Abdullayev is scheduled to meet on January 16 with Turkish Parliamentarian Taner Yildez, whom Prime Minister Erdogan has authorized to represent him in discussions with SOCAR, and SOCAR officials are hopeful that this new channel can expedite progress. If Azerbaijan and Turkey cannot reach agreement, StatoilHydro officials say that the Shah Deniz Consortium is increasingly contemplating the possibility of selling at least some Shah Deniz Phase Two volumes to Gazprom, possibly as part of a swap deal, although SOCAR has previously assured the USG that it would never sell appreciable SD2 volumes to Russia. EU Commissioner Benita Ferrero-Waldner will be visiting Baku on January 21 to discuss, inter alia, energy issues. END SUMMARY.

12. (C) On January 15, EnergyOff met separately with Murad Heydarov, advisor to SOCAR President Rovnaq Abdullayev; Olav Skalmers, StatoilHydro Vice-President for Marketing; and, Richard Ruddiman, BP Azerbaijan's Shah Deniz gas commercial manager, to discuss the status of Shah Deniz Phase one (SD1) and Shah Deniz Phase Two (SD2).
FERRERO-WALDNER VISIT

13. (C) SOCAR Presidential Advisor Murat Heydarov said that EU Commissioner Benita Ferrero-Waldner would be visiting Baku on January 21 to discuss (inter alia) energy issues, and that he was traveling to Vienna on January 18 to meet with EU staff to help prepare for the meeting. This Ferrero-Waldner visit grew out of discussions with European Commission Energy Commissioner Piebalgs during his visit to the November 13-14 Baku Energy Summit, during which he and GOAJ officials agreed to intensify EU-GOAJ energy cooperation. Since the recent Ukraine-Russia gas dispute, Heydarov said he senses far greater enthusiasm for Nabucco from his EU interlocutors.
SD1) OFFICIAL NEGOTIATIONS

14. (C) Heydarov denied that Botas has made any upwards revision in the price it was offering for SD1 gas (see reftel C). Explaining, he said that there are two fora for discussing SD1 price. The major and official forum is the negotiations between Botas (buyer) and the Azerbaijan Gas Supply Company (AGSC) the gas marketing company for Shah

Deniz Phase One gas, headed by StatoilHydro). The last meeting of this forum was in October 2008, with a subsequent meeting in December cancelled. In this forum Botas has continued to adhere to its long-standing proposal of raising the SD1 gas price cap (i.e. maximum allowable price) the first year by 20 percent, followed by 10 percent raises in the second and third years. Heydarov explained that what this would mean is that for the first year the price of SD1 would be at most USD 144 per thousand cubic meters (tcm), and in the third year the price would be approximately USD 180/tcm. At that point, this price would have to remain for four successive quarters before price renegotiations could resume, which means that for all intents and purposes, the pricing mechanism arrived at during this phase of negotiations would last for (at least) four years. Since Botas's proposal results in a price that is severely sub-market, the AGSC Consortium refuses to consider it (COMMENT: StatoilHydro Gas Marketing VP Olav Skalmers explained to EnergyOff that even with the current low oil prices, the resulting SD1 gas price using the current pricing formula would exceed USD 180/tcm.) The next meeting of this forum is scheduled for January 27. SD1 & SD2) UNOFFICIAL NEGOTIATIONS

15. (C) Heydarov explained that outside this formal negotiating forum, there is a parallel, supplementary forum in which government and energy officials from both countries meet to discuss possible solutions for SD1 and SD2. On the GOAJ side, this group's regular and revolving participants include Energy Minister Natiq Aliyev, SOCAR President Rovnaq Abdullayev, and SOCAR Marketing Vice-President Elshad Nasirov; on the GOT side, Energy Minister Guler and Botas President Duzyol. This group met during this November 13-14

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Baku Energy Summit, during which, according to SOCAR President Abdullayev, Energy Minister Guler was about to sign an Energy MOU with Azerbaijan but "backed out at the last minute"(ref A).

SOCAR WILLING TO GIVE 4 BCM TO TURKEY

16. (C) In late November, Energy Minister Aliyev, SOCAR President Abdullayev and VP Nasirov traveled to Ankara at Energy Minister Guler's invitation to meet with him to discuss SD and SD2 issues. Their already unfavorable opinion of Guler was worsened when he kept them waiting five hours, as he was "out of the capitol." In this late November meeting SOCAR's proposal to Botas was that it would sell a minimum of four billion cubic meters annually (bcm/a) to Turkey, with the possibility of more volumes, in exchange for the right to transit seven bcm/a to Europe. Turkey refused this offer, insisting on eight bcm/a for its own energy needs.

THEN 8 BCM

17. (C) In a December 5 meeting (reftel b) SOCAR's latest proposal was that it would accede to GOT demands to sell eight billion cubic meters annually (bcm/a) to Turkey. Heydarov explained that previously SOCAR was reluctant to commit eight bcm/a of SD2 to the Turkish market, since it needed a minimum of seven bcm/a for transit to Europe in order to sanction one of the competing pipeline projects (Nabucco, TAP, TGI) (COMMENT: SD2 production is anticipated to be between 13-16 bcm/a, three of which would be needed for the Azerbaijani and Georgian markets. Of this remaining 10-13 bcm/a, if seven were for European markets, only three to six bcm/a would be left for Turkey. END COMMENT). However, in order to meet Turkey's demand for eight bcm/a, while still having seven bcm/a for Europe and three for Georgia/Azerbaijan, Heydarov said that SOCAR would try to get increased gas production from existing SOCAR fields (shallow-water Gunashli), the 'Bahar' field, or from ACG associated gas.

18. (C) However, in exchange for providing eight bcm/a, SOCAR insisted that it be allowed to sell SD2 gas consistent with existing GOT gas market liberalization laws, which would allow it to sell gas to any licensed buyer, i.e. not being forced to sell to BOTAS. In this way, SOCAR felt it could get a fair market price for SD2 gas within Turkey. As Heydarov explained it to EnergyOff, "although SOCAR willing

to meet Turkey's energy security needs, that doesn't mean it is willing to meet Botas's energy security needs." However, Heydarov said that GOT and Botas refused this proposal also, insisting that SD2 gas be sold to Botas and only Botas.

¶9. (C) As for SD1 gas, Heydarov said that even though the two countries' respective presidents in their recent bilateral meetings have agreed that the price of Azerbaijani gas being sold to Turkey is too low, there has still be no hint of an agreement about a new, more realistic price, in either the formal or informal forum. In the latter, Heydarov said that Botas has implied that it would be willing to raise price caps to allow a price of USD 250-270 at oil prices of USD 100 per barrel, but has made no concrete proposals. Heydarov explained that while the GOT would like to separate the issues of SD1 and SD2, for the GOAJ that is not feasible, as it sees GOT unwillingness to pay anything close to market price for SD1 as an indication of bad faith that weakens GOT assertions that it is willing to pay 'market price' for SD2 gas.

¶10. (C) Referring to the SD1 price formula, Heydarov said international best practices for gas marketing are for a price formula that is 100 percent 'oil weighted,' i.e. where the gas price is a direct function of the oil price. However, the current PSA-stipulated SD1 pricing formula is only 60 percent 'oil weighted,' and has a price cap. The final gas price is arrived at by adding a fixed element (USD 100 per thousand cubic meters) to a variable. SOCAR and SD Consortium want to revise the price formula to abolish price caps and to raise the fixed element upwards from USD 100, but Botas (understandably) likes the current formula.

¶11. (C) Heydarov said that on December 23 SOCAR President Abdullayev met with GOT Prime Minister Erdogan to brief him on SD1 and SD2 developments, mainly because SOCAR felt that the Prime Minister was not getting an accurate assessment of the situation from Energy Minister Guler. Erdogan was "attentive," "promised to look into the matter deeply," and As a result of this meeting Erdogan authorized his energy

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advisor (and Parliamentarian) Taner Yildez as his point of contact for SOCAR President Abdullayev. Heydarov said the assignment of Yildez as POC pleased SOCAR, as now it feels it is less dependent on Energy Minister Guler and Botas President Duzyol, both of whom it considers unreliable and not empowered to make the necessary decisions.

¶12. (C) Heydarov said that SOCAR President Abdullayev and VP Nasirov are scheduled to meet Yildez in Ankara on January 16.

At that time they hope to get feedback to the December 15 letter from GOAJ Energy Minister Aliyev outlining the latest GOAJ SD2 proposal, which offered eight bcm/a of gas for Turkey (but not necessarily Botas) in exchange for the right to transit seven bcm/a to European markets.

¶13. (C) In discussing the price of SD2 gas to Turkey with EnergyOff, Heydarov admitted that it is unlikely that the final price would be equal to a "pure market price," as political considerations would also be taken into account. As such, it was likely any final SD2 price would be discounted below the Gazprom and Iranian prices into Turkey. He said that the GOAJ argument to Turkey has been (inter alia) that it can glean significant additional revenues from being a transit country, given that (for example) it could charge o/a three Euros per thousand cubic meters per kilometers, which could mean significant revenues given Turkey's size and possible transit volumes of up to 50 bcm/a.

Given that there are only three possible transit countries for eastern gas seeking European markets (Ukraine, Belarus and Turkey) and especially given the recent Russia-Ukraine problems, Heydarov said it would seem to be in Turkey's interest to exploit its transit potential.

¶14. (C) As for plans for SD2 development, Heydarov confirmed that full field development start-up has been delayed, and that consequently SD2 development budget has been revised downwards. The latest estimate for SD2 "first gas" is third quarter 2015 at the earliest.

BP/STATOILHYDRO) NO PROGRESS

¶15. (C) In a subsequent meeting with StatoilHydro

Vice-President for Marketing Olav Skalmoros and BP Azerbaijan's Shah Deniz gas commercial manager Richard Ruddiman, both said that there had been no progress in SD1 price negotiations with Botas, with the latest offer still being the one that would result in a price over three years of approximately USD 180/tcm. Skalmoros said that the SD Consortium was increasingly moving towards at least starting arbitration, since "no one in Turkey except the Prime Minister is able to make any decision." SOCAR is relatively reluctant to begin arbitration due to reasons of Turkic solidarity. As for SD2, he confirmed development delays, saying that although third quarter 2015 is now the earliest start date of 'first gas,' the SD Consortium is not excluding the possibility of first gas in 2016 or 2017.

¶16. (C) Referring to SOCAR's latest proposal to be allowed to sell SD2 gas to any licensed buyer in Turkey, Skalmoros said the idea was a non-starter, since although any licensed entity could sell gas in Turkey, only Botas could import it. Given that Botas's desire was to maintain its gas monopoly within Turkey, it would never allow another SOCAR's proposal. GAZPROM LOOKING GOOD FOR SD2?

¶17. (C) Commenting on the many recent trips of SOCAR to Moscow, Skalmoros said that the Shah Deniz Consortium looks favorably upon Gazprom and "would have no problem" selling SD2 gas to Gazprom, who is willing to pay market prices for it. Negotiations in this regard are relatively advanced, and the SD Consortium to include SOCAR are even paying increased attention to the possibility of doing a swap deal with Gazprom with SD2 gas, where the SD Consortium sells an amount to Russia, then receives an equivalent amount from Russia in Europe. According to Skalmoros, "building 120 kilometers of pipeline in the Caspian sand" is a lot easier and cheaper" than building Nabucco.

¶18. (C) COMMENT: SOCAR is encouraged by the separate channel it has set up with the Prime Minister's office and with Taner Yildez, as it feels that it is only the President or Prime Minister who will ultimately be able to make a deal on gas for the Turkish government. Separately, information gleaned from SOCAR, StatoilHydro and BP Azerbaijan conflicts with the Ref C, with the three stating there has been no real movement in Botas's proffered price in either the official forum or in unofficial discussions. Although the Embassy believes that StatoilHydro's laudatory comments about Gazprom

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and the SD Consortium's willingness to sell to it were intended to persuade as well as to communicate, there is no doubt that any continued inability to reach agreement with Turkey on either SD1 or SD2 would increasingly push the SD Consortium to consider its other marketing options. It should be kept in mind that SOCAR has previously assured Embassy interlocutors that despite commercial negotiating activity with Gazprom, it would never sell appreciable amounts of SD2 gas to Russia. Embassy will get a readout of the January 16 Yildez-SOCAR meeting as soon as possible. END COMMENT
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